

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 99-0029
Gross Income Tax
For Tax Year 1997**

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ISSUE

I. Gross Income Tax—Low Rate versus High Rate Classification of Income Received from Sale/Leaseback of Production Equipment

Authority:	IC § 6-2.1-2-1	45 IAC 1-1-11
	IC § 6-8.1-5-1	45 IAC 1-1-13
	IC § 6-2.1-1-12	45 IAC 1-1-14
	IC § 6-2.1-2-4(4)	45 IAC 1-1-17
	IC § 6-2.1-2-3	45 IAC 1-1-21
	IC § 6-2.1-2-5 (8)	45 IAC 1-1-22
	IC § 6-2.1-1-9	45 IAC 1-1-85
	IC § 6-2.1-2-5(9)	45 IAC 1-1-86
	IC § 6-2.1-2-7	45 IAC 1-1-88
		45 IAC 1-1-107

Taxpayer protests the reclassification of income received on a sale and leaseback transaction from the low rate to the high rate of taxation.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation, 98% of which is owned by a Japanese corporation. Taxpayer manufactures and wholesales piston parts for large tractor and truck engines. The Department audited taxpayer for tax year 1997, finding that all taxable revenue was reported but not correctly classified between the high and low rates of taxation for gross income tax purposes. The Department reclassified some low rate income to that of high rate. This reclassification led to proposed assessments of Indiana gross income tax. Taxpayer timely protested these assessments. The Department requested that taxpayer provide additional information. Taxpayer has done so. Further facts will be supplied as required.

I. Gross Income Tax—Low Rate versus High Rate of Classification of Income Received from Sale/Leaseback of Production Equipment

DISCUSSION

Taxpayer protests the reclassification of income received on the sale/leaseback of production equipment from the low rate pursuant to IC § 6-2.1-2-4 to the high rate of taxation pursuant to IC § 6-2.1-2-5. *See also*, 45 IAC 1-1-22 and 45 IAC 1-1-107. The Department's audit of taxpayer revealed that taxpayer sold certain production equipment—two lathes and a sawing machine—to a leasing company who then leased the equipment back to taxpayer. Taxpayer classified the sale as wholesale sales and included the sales proceeds as low rate income for gross income tax reporting purposes. Taxpayer had originally purchased the equipment from the parent corporation and sold it 6 months later to the equipment leasing company. The auditor reclassified the proceeds as receipts from a sale of capital assets pursuant to 45 IAC 1-1-21 because of how taxpayer treated the transaction in its own corporate records.

Taxpayer did not treat the transaction as a sale at wholesale on its internal financial statements and federal income tax return. The transaction was not characterized as a sale at wholesale within their accounting system. Rather, for federal income tax purposes, taxpayer characterized the proceeds from the sale/leaseback transaction as a \$283,652 short-term capital gain. Taxpayer had purchased the equipment for \$1,893,652 and sold it for \$2,177,080. The information from taxpayer's federal tax return clearly contradicts taxpayer's assertion that there was no mark up on the sale of the equipment to the leasing company.

Within its own internal financial statements and accounting system, taxpayer treated the proceeds from the transaction as a "deferred gain on sale leaseback of equipment;" the transaction itself is listed in a section of taxpayer's internal documents entitled "Assets, Property and Equipment." (emphasis added). Taxpayer's "Unaudited Statement of Cash Flows" treats the proceeds from the transaction as "investing activities." Further, taxpayer's "Notes to Financial Statements," under "Leases," show the transaction as a "sale and leaseback . . . resulting in a gain . . . to be recognized ratably over the life of the lease." Finally, under "Income Taxes," the proceeds were treated as "gain on sale and leaseback."

Taxpayer argues in its Letter of Protest that it purchased the production equipment with the intent to resell it in the same form that it was purchased, holding it primarily for sale to a customer in the regular course of business. *See*, IC § 6-2.1-2-1. Taxpayer claims that whenever it has purchased equipment, it has always sold the equipment in a sale and leaseback transaction. Taxpayer claims the property was never used before its sale and the price was not marked up. In the alternative, taxpayer argues that the transaction was a sale at retail, thus qualifying for the low rate of taxation pursuant to IC § 6-2.1-2-1(b)(1). Taxpayer states it was acting as a retail merchant who, in the ordinary course of its business, transferred production equipment with the intention of reselling it.

Under IC § 6-8.1-5-1(b), a “notice of proposed assessment is *prima facie* evidence that the department’s claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.” Therefore, taxpayer has the burden of proof in showing that the Department’s classification of the income received from the transaction at issue is incorrect. Generally speaking, “gross income means all the gross receipts a taxpayer receives from (1) trades, businesses, or commerce; (3) from the sale, transfer, or exchange of property, real or personal, tangible or intangible; (10) from any other source not specifically described in this subsection.” IC § 6-2.1-1-2. *See also*, 45 IAC 1-1-17. The less complex issue raised by taxpayer’s protest concerns taxpayer’s argument in the alternative, i.e., is taxpayer a retail merchant and thus is the income received from the transaction at issue subject to the low rate of taxation?

For gross income tax purposes, a retail merchant means “a taxpayer who is regularly and occupationally engaged in the business of purchasing tangible personal property and providing the tangible property to his customers at a fixed and established place of business.” IC § 6-2.1-1-12. Taxpayer is not a retail merchant. *See also*, IC § 6-2.1-2-1(b)(1), 45 IAC 1-1-11, 45 IAC 1-1-13, and 45 IAC 1-1-14. A retail sale is a transaction in which the tangible personal property is transferred for consideration **“in the ordinary course of the seller’s regularly conducted business.”** (45 IAC 1-1-13(3); emphasis added). Taxpayer’s “ordinary course” of “regularly conducted business” is the manufacture of piston parts for sale at wholesale; taxpayer’s “fixed and established place of business” is a manufacturing plant, not a retail store. Therefore, IC § 6-2.1-2-4(4) does not apply. The proceeds from the transaction at issue cannot be subject to the low rate of taxation under taxpayer’s theory that the sale of the production equipment was a retail sale. *See also*, 45 IAC 1-1-88, the regulation providing for the low rate of tax for retail sales. Therefore, taxpayer’s argument in the alternative must fail.

The more complex issue concerns taxpayer’s primary argument, that the income received from the transactions at issue falls under IC § 6-2.1-2-4(1); that is, the income qualifies for low rate treatment as a wholesale sale. First, IC § 6-2.1-2-3 sets forth 2 separate rates of tax for different classes of transactions:

- (a) The receipt of gross income from transactions described in section 4 of this chapter is subject to a tax rate of three-tenths of one percent (0.3%).
- (b) The receipt of gross income from transactions described in section 5 of this chapter is subject to a tax rate of one and two-tenths percent (1.2).

The low rate of taxation applies to, among other transactions, retail and wholesale sales. IC § 6-2.1-2-4. The high rate of taxation applies to, among other things, activities described in other Indiana tax statutes. *See*, IC § 6-2.1-2-5(8). The other Indiana statutes applicable to taxpayer’s transactions are IC § 6-2.1-1-9 and IC § 6-2.1-2-5(9).

IC § 6-2.1-2-4 states that the “receipt of gross income from the following is subject to” the low rate of taxation: “(1) wholesale sales” and (4) selling at retail.” Subsection 4 does not apply

because taxpayer is not a retail merchant under IC § 6-2.1-1-12 or under 45 IAC 1-1-11 (a retail merchant is a taxpayer who is regularly and occupationally engaged in the business of purchasing and reselling or renting tangible personal property). *See* discussion, *supra*. Therefore, the income received from the transaction at issue does not constitute gross income received by selling tangible personal property at retail. Subsection 1 applies if taxpayer's transaction falls within the ambit of IC § 6-2.1-2-1(c)(1) definition of wholesale sales:

(c)(1) "Wholesale sales" means any sale described in this subsection in which the purchaser is not a division, subdivision, agency, instrumentality, unit, or department of government:

(A) Sales of tangible personal property (except capital assets or depreciable assets of the seller) for resale in the form in which it was purchased.

(B) Sales of tangible personal property which is to be directly consumed in direct production by a purchaser in the business of producing tangible personal property by manufacturing, processing, refining, repairing, mining, agriculture, or horticulture.

(C) Sales of tangible personal property to be incorporated as a material or integral part of tangible personal property produced by a purchaser in the business of manufacturing, assembling, constructing, refining, or processing.

See also, 45 IAC 1-1-88, which sets forth the low rate of taxation for retail sales.

An equipment leasing company purchased the equipment, not a consumer for its own personal use or a vendor for resale purposes. Subsection (B) of IC § 6-2.1-2-1(c)(1) does not apply, as the purchaser is an equipment leasing company, not a purchaser who produces tangible personal property by any of the means set forth in subsection (B). Subsection (C) does not apply because the purchaser, an equipment leasing company, is not a purchaser who incorporates tangible personal property as a "material or integral part of tangible personal property" in manufacturing, etc.

At first blush, subsection (A) seems to apply; taxpayer argues in its Letter of Protest that it purchased the equipment from its parent corporation for "resale in the form in which it was purchased." However, the parenthetical statement in subsection A excludes "capital assets or depreciable assets of the seller." Capital assets include "all assets except stock-in-trade of a retail merchant held primarily for sale to a customer in the regular course of a trade or business. Receipts from the sale of capital assets are taxed at the higher rate . . ." 45 IAC 1-1-21.

The Department finds that for Indiana gross income tax purposes, the income should be taxed at the higher rate pursuant to IC §§ 6-2.1-2-5(8), 6-2.1-2-5(9), and 6-2.1-1-9. This finding is consistent with taxpayer's own characterization of the proceeds received from the transaction at issue for federal income tax purposes and for its own bookkeeping records. Taxpayer's

transaction falls squarely within the ambit of 45 IAC 1-1-22: “The gross income received from a complete sale and transfer of ownership of . . . capital assets . . . is subject to gross income tax and is taxable at the higher rate.”

FINDING

Taxpayer’s protest concerning the reclassification, from the low rate to the high rate of taxation, of gross income received on the sale and leaseback of production equipment, is denied.